

Internal Revenue Service
memorandum

CC:TL:Br3
WEArmstrong

date: NOV 12 1986

to: District Counsel, Washington, D.C. MA:WAS

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED]

This is in response to your August 19, 1986 memorandum for technical advice in the above-entitled case, which was received by this office on September 4, 1986.

ISSUE

(1) Whether the "late-payment penalties" paid by taxpayers on their home mortgage are deductible as interest under I.R.C. section 163. 0163.17-00.

(2) Whether the "late-payment penalties" imposed on taxpayers with respect to their home mortgage, can be disallowed as an interest deduction by the Service on grounds that they are penalties rather than interest or service charges. 0163.17-00.

CONCLUSION

Whether "late-payment penalties" paid by taxpayers on their home mortgage are deductible as interest under I.R.C. section 163 depends on what the penalties are for. If they are simply a charge for late payment and the forbearance of money they are deductible as interest; if they are to cover costs for the service of handling overdue accounts they are not deductible as interest under I.R.C. section 163.

Additionally, we believe that mortgagees, because of their commercial nature, their competitive environment and the fact that many, like banks, are regulated, do not exact from mortgagors payments in the nature of fines and penalties that are punitive, as do governmental entities. Thus, we do not think that the Service can argue successfully that the late-payment penalties were imposed for the purpose of penalizing delinquent mortgagors.

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FACTS

In [REDACTED], [REDACTED] imposed a late-payment penalty or charge equal to five percent of the mortgage payment due whenever a mortgage payment was received by it after the 17th of the month. The late-penalty or charge remained the same whether the mortgage payment was received one day late or six months late. Further, the bank did not charge any amount denoted "interest" on a late-payment and the late-payment penalty or charge was in lieu of any other charges (e.g. interest). Taxpayers, during [REDACTED], paid \$ [REDACTED] in late-payment penalties or charges to [REDACTED] on their home mortgage.

Rev. Rul. 74-187, 1974-1 C.B. 48, holds that a late-payment charge assessed by a public utility, no part of which is for a specific service performed in connection with the customer's account, is deductible as interest. In your technical advice request you state that Rev. Rul 74-187 seems to indicate that if a late-payment penalty is not for services, then it must be interest. You further state that such rationale does not allow the opportunity for disallowing the deduction of a late-payment penalty on the grounds that it is a penalty, rather than interest or a service charge. Also, you state that it may be incorrect to characterize in this situation a penalty as interest, especially when the penalty is based on a set percentage of the amount owed and does not increase in amount after the initial assessment.

You seek the benefit of our views in this matter because your position that the late-payment penalties or charges are not interest, conflicts with Rev. Rul. 74-187 if it cannot be proven that the entire amount of the penalty payment is for services.

DISCUSSION

Interest is an expense that is expressly deductible for tax purposes. I.R.C. section 163. It has been defined as the amount one has contracted to pay for borrowed money, Old Colony Railroad Co. v. Commissioner, 284 U.S. 552 (1932); and as the compensation allowed by law or fixed by the parties for the use, or forbearance, or detention of money. Fall River Electric Light Co. v. Commissioner, 23 B.T.A. 168 (1931).

It is well established, following the rationale of substance over form, that what a payment or charge is denominated need not be its true character for tax purposes. Kena, Inc., v. Commissioner, 44 B.T.A. 217 (1941). Rather, the facts of the transaction control its character, not the terminology. Rev. Rul. 72-315, 1972-1 C.B. 49. Therefore, a late-charge or late-penalty may be interest for tax purposes though not called such, or, if it had been called interest, it need not be.

In Sharp v. Commissioner, 75 T.C. 21 (1980), aff'd, 689 F.2d 87 (6th Cir. 1982) taxpayer was ordered to pay a lump sum to his former wife, in connection with a judgment. In accordance with Kentucky law, he posted a supersedeas bond to stay execution, pending the outcome of his appeal, on that part of the judgment ordering the lump sum payment. Although his appeal was partially successful and the amount of the lump sum award was reduced, under Kentucky law he was required to pay to his former wife an additional sum, denoted as damages, equal to ten percent of the amount of the superseded judgment which was affirmed on appeal. In holding that the damages did not constitute deductible interest under I.R.C. section 163, the Tax Court found that the principal purpose of the damage assessment was not to compensate the judgment creditor for the use of her funds while the appeal was pending, but to deter frivolous appeals and to penalize those appellants who needlessly delay an end to litigation by docketing their appeal.

In Reinhardt v. Commissioner, 72 T.C. 47 (1980) taxpayers paid a delinquency penalty, a redemption penalty, as well as delinquent taxes in order to redeem their property from the state. The redemption penalty was computed by multiplying one percent of the delinquent taxes by the number of months of delinquency, while the delinquency penalty was six percent of the delinquent taxes. Noting that the six percent delinquency penalty remained a constant amount no matter how long the delinquent taxes remained unpaid and that the state charged the penalty in order to encourage its taxpayers to pay their taxes on time, the Tax Court held that the delinquency penalty was not interest; Compare Hyde v. Commissioner, 64 T.C. 300 (1975) (where the Tax Court held that a flat six percent statutory redemption fee paid by a taxpayer to the purchaser of foreclosed property, over and above the purchaser's bid price on the redeemed foreclosed property, was interest. There the statutory fee was payable to a private lender and was found by the Court to be essentially consideration paid for an effective extension of a mortgage loan).

With respect to the redemption penalty, the Tax Court in Reinhardt found that although deemed a "penalty" by the state, this charge, which accrued over time like interest, was in effect for the forbearance of the state. Thus, the Tax Court held that the redemption penalty was deductible as interest.

Amounts paid for specific services, and not for the use of money are not deductible as interest. Enoch v. Commissioner, 57 T.C. 78 (1978). As a result, the Service does not allow as an interest deduction any portion of a finance charge or late-payment charge assessed for specific services performed by the lender in connection with the borrower's account.

In Rev. Rul. 72-315, which concerns the deductibility of finance charges paid on a revolving charge account, the Service stated that a charge that is not paid for the use or

forbearance of money but is paid to compensate the lender for the cost of specific services performed in connection with the borrower's account does not qualify as interest but is a service charge. Similarly in Rev. Rul. 74-187, which concerns a public utility that charges an additional five percent if a bill is paid more than 20 days after the due date, the Service held that, in the absence of evidence that the late-payment charge assessed by the public utility is for a specific service performed in connection with a customer's account, such late-payment charge is deductible as interest under I.R.C. section 163.

It should be noted that the fact that a late-payment charge is a one-time charge does not preclude a finding that it is interest, see Rev. Rul. 69-188, 1969-1 C.B. 54, (holding that a "loan processing fee" (points), a one-time charge, paid by a mortgagor-borrower as compensation to a lender solely for the use or forbearance of money is considered to be interest); see also Rev. Rul. 77-417, 1977-2 C.B. 60 (charges levied by a bank on customer credit card accounts in the form of a one-time charge of two percent of each new cash advance and one percent of each new check and overdraft advance, in addition to the monthly finance charge, are deductible as interest provided the charges are not for services performed in the maintenance of the account). Further, it should be noted that the effective rate of a late-payment charge also does not preclude a finding that it is interest. See Rev. Rul. 72-2, 1972-1 C.B. 19.

It can be concluded, based on the above, that whether the late-payment penalties or charges in the instant case are deductible as interest depends on what the charges or penalties are for. Are they simply a charge for late payment, or are they to cover costs for the service of handling overdue accounts or are they punitive?

Generally, mortgagees (e.g. banks, savings & loan,) base their interest rates on what they consider to be a fair rate of return on the money they lend. Therefore in fixing their interest rates, mortgagees take into account all costs incurred in providing a mortgage loan. Such mortgage loan costs include administrative costs as well as costs incurred to obtain the funds loaned to mortgagors. The cost of normal billing and collection is a part of the administrative cost of providing mortgage loans that is taken into account in establishing the rate of interest. In addition there may be some costs associated with handling overdue accounts.


If, in the instant case, there is evidence that the late-payment penalties or charges are to cover the additional costs incurred due to the special handling of overdue accounts, the late-payment penalties or charges are for the purpose of covering costs incurred due to the special handling

of the overdue accounts and are not interest. However, absent such facts, we do not think a meaningful argument can be made to distinguish the instant late-payment penalties or charges from the late-charges set out in Rev. Rul. 72-315 and Rev. Rul 74-187.

Additionally, we believe that mortgagees, because of their commercial nature, their competitive environment and the fact that many, like banks, are regulated, do not exact from mortgagors payments in the nature of fines and penalties that are punitive, as do governmental entities. Thus, we do not think that the Service can argue successfully that the late-payment penalties or charges, were imposed for the purpose of penalizing a delinquent mortgagor. Cf. Rev. Rul. 57-198, 1957-1 C. B. 94 (which holds that penalty payments made by a taxpayer to his mortgagee for the privilege of prepaying his mortgage indebtedness are deductible as interest under I.R.C. section 163).

In conclusion, we do not believe, absent clear evidence to the contrary, that the Service can argue successfully that late mortgage payment penalties or charges are not deductible as interest on grounds (e.g. they are penal) other than that they are charges for specific services, such as handling delinquent accounts. Moreover, we believe that IRS Publication 17 (Rev. Nov. 85) which states at page 128 that a taxpayer may deduct a late-payment charge if it was not for a specific service performed by a mortgage holder, precludes the Service from effectively challenging the deductibility of late mortgage payment penalties or charges on any grounds other than that such penalties or charges are for a specific service performed by the mortgagee.

ROBERT P. RUWE
Director


SOMMERS T. BROWN
Senior Technician Reviewer
Branch No. 3
Tax Litigation Division